Chapter Four

A BROADER VIEW OF ECONOMIC SECURITY

Being bigger or richer than other countries is not, of course, a strategy for enhancing economic security that is open to most countries. We cannot all be bigger or richer than everybody else. Neither can all countries hope to be internationally dominant in a broad range of industries or industrial processes. Certainly, not all countries can aspire to being militarily dominant.

Even for the few large countries (for example, the United States or, within the European context, Germany) or groupings of countries (e.g., the EU) that might have a reasonable chance of gaining sufficient economic bulk to shape the world to their liking, a strategy of relying simply on size—whether relative or absolute—is no longer adequate. The United States was not sufficiently large or self-sufficient, for example, to be insulated from the consequences of reductions in oil output engineered by OPEC in the 1970s and 1980s. Neither has the United States in recent years been sufficiently dominant in international financial affairs to stabilize foreign exchange rates or to convince other countries to adopt policies that might lead to exchange-rate stability. Neither would the United States have been able unilaterally to prevent a contraction of world trade or to insulate itself from the consequences of such a contraction, had the recent round of multilateral trade negotiations unraveled. The United States is not and will probably never again be the world's leader in all advanced technologies and industrial processes.[1]

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[1]Nor should we want to be. Natural endowments, local market conditions, history, and circumstances impart relative advantages to different countries in the development and exploitation of different technologies. Just as overall welfare is increased if

This state of affairs is not necessarily bad. U.S. inability to shape all aspects of the global economy or to dominate all aspects of global commerce is the result, at least in part, of U.S. integration into the world economy. This integration allows specialization. The United States no longer has to do everything for itself; for some things, it can rely on others. With this specialization comes increased efficiency and increased output for all concerned.

Seeking economic security simply through size, control, and relative economic performance is, in essence, seeking to avoid the negative consequences of external developments. If we are big and/or isolated from the world, most things that happen beyond our borders will not hurt us much. If we are dominant enough to shape the rules of the game, the desires and policies of other nations will not bother us very much. If our firms are securely dominant, we need not worry about commercial or industrial developments elsewhere.

An alternative approach (really a supplementary or complementary approach) is to seek to minimize the likelihood that negative external events will occur in the first place. In addition to doing what it can to limit its vulnerability to negative external developments, the United States should also seek ways to minimize international economic instability of the sort that may generate undesirable developments. The pursuit of international economic stability is closely analogous to and has much the same motivation as long-standing U.S. efforts to counter international political instability. As we will see in the remainder of this chapter, pursuing U.S. economic security will in many cases turn out to be the same thing as pursuing international economic stability.

MAINTAINING ACCESS TO FOREIGN MARKETS

The United States was created, in part, because residents of the American colonies bridled at trade restrictions imposed on them by the English government. Ever since, efforts to maintain and expand U.S. access to foreign markets—for purposes of both buying and selling—have constituted a central element of U.S. foreign and economic policy.

nations specialize in areas of production where they enjoy a comparative advantage, gains in overall welfare will likely result from international specialization in technological development.

Integration of U.S. commercial and financial affairs with those of other countries unquestionably creates a certain susceptibility to shocks emanating elsewhere in the world. But by providing expanded markets for U.S. products, a wider range of choice for U.S. consumers, new opportunities for productive investments by Americans, and new sources of financing for private and public undertakings in the United States, this integration has also served to enhance the economic well-being of all U.S. residents. Today, much more so than in the 18th century, the economic well-being of U.S. residents depends on their ability to buy and to sell goods, services, and financial instruments in markets all over the world. And today, no less than in the 18th century, actions by foreign governments can and too frequently do restrict the freedom of U.S. resident to do so. Consequently, a major objective of U.S. economic security policy must be to protect and expand access by U.S. residents to foreign commercial and financial markets.

At the most basic level, U.S. economic security requires a reliable supply of the commodities and products necessary to support U.S. lifestyles and U.S. economic activity. Without doubt, the United States has the resources, the technological know-how, and the flexibility eventually to work around disruptions in the supply of nearly any commodity. Sudden supply interruptions of important commodities can nonetheless cause us considerable pain as, of course, the oil shocks of the 1970s and early 1980s illustrated. Decisions by Middle Eastern oil producers never threatened the political viability of the United States, of course. Nor did OPEC policies ever hold the potential for reducing U.S. GDP by any more than a few percentage points. Still, developments in international oil markets did cause inconvenience and lost production in the United States of a scale sufficient at least to tempt U.S. government officials to alter U.S. foreign and military policies. In this regard, U.S. sovereignty was to a degree compromised. Neither its economic nor its political security was absolute in the face of decisions by foreign oil producers.

The memory of the oil crises is fading today, but alarmists still call occasionally for U.S. government policies to decrease alleged U.S. "dependence" on foreign sources for this or that "essential" product or service. Frequently, the remedial policies proposed seek to increase the self-sufficiency of the United States in the production of the allegedly essential commodity.

But those who advocate policies of increased self-sufficiency have (except as noted above in the cases of some specialized military hardware) learned the wrong lesson from the oil crises of a decade and more ago. Self-sufficiency would not and should not have protected the United States from the consequences of sudden reductions in output by Middle East oil producers. Even if the United States had been completely self-sufficient in oil production, it would still have been wise to allow oil prices in the United States to rise along with world prices. To be sure, rapidly changing oil prices would have (in fact, did) cause considerable turmoil and impose considerable costs as factories, residences, transportation systems, etc., were restructured to reduce the use of suddenly more expensive oil. But to have ignored the high foreign price of oil, to have lived within U.S. self-sufficiency, refusing to sell U.S.-produced oil to the rest of the world, would have been to turn our backs on an opportunity to trade a U.S.-produced product for foreign-produced non-oil goods and services at suddenly much more advantageous terms of trade.

The pain caused by the oil shocks was caused by the rapid change in the relative price of an important commodity. The United States could have avoided this pain only by isolating itself from the larger world economy, a policy that would almost certainly have caused much greater pain. The aim of U.S. policy should not be self-sufficiency and the isolation that necessarily accompanies self-sufficiency, but rather a stable and dependable supply of important commodities, no matter where they are produced.

Oil was and remains today a special case among internationally traded commodities. No other commodity is as central to the functioning of modern industrialized economies and as difficult to find substitutes for in the short run. And the production of no other important commodity is as concentrated in politically unstable parts of the world. U.S. efforts to reduce tensions in the Middle East and to counter the rise of potentially destabilizing regional powers (Iraq, Iran) are important components of U.S. economic-security policy. U.S. economic security will be further enhanced by policies that help

to reduce the concentration of production of important commodities in a few countries or a few regions of the world. U.S. aid to develop the oil export potential of Russia or Kazakhstan, for example, will reduce the concentration of world oil production in the Middle East and thereby increase U.S. and global economic security. Similarly, U.S. trade policies that allow imports of South Korean semiconductors will make it less likely that Japanese producers will achieve monopoly power in particular segments of this market. This kind of development will reduce concentration and enhance economic security.

Traditional thinking about economic security emphasized our access to market as buyers—whether or not we could depend on the supply of products we needed. More recently, attention seems to be shifting to the problems of market access as sellers—whether we will be able to sell our products in foreign markets. This is a legitimate concern. Buying and selling in international markets are, of course, intimately linked. Even if everyone is willing to sell to us, we cannot buy goods in international markets unless we are also able to sell there. We cannot indefinitely import more than we export. The prosperity and economic security of Americans depends just as much on our ability to sell as on our ability to buy.

But it is unlikely that U.S. producers can unilaterally enjoy access to foreign markets. U.S. access to foreign markets can be sustained in the long run only as part of a larger trading system that provides access for all producers to foreign markets. U.S. economic-security interests, then, will be served by promoting the worldwide expansion of international trade and investment and the elimination of barriers to such activities. International trade and investment are the basic building blocks of international economic relations, and the preservation of a stable international trading and investment environment is essential for preserving international economic stability. The experience of the 1930s provides a chilling illustration of the potential economic and political consequences of failure to maintain the international trading order.

Views differ sharply today on how best to promote international trade and to increase U.S. access to foreign markets:

- Through a renewed commitment to and possibly an extension of the principles of multilateralism and nondiscrimination (as exemplified in the GATT) or through the pursuit of bilateral or regional free-trading arrangements *à la* NAFTA?
- Through continued pursuit of the ideal of liberal (in the sense of free or market-determined) trade or through a more interventionist approach in which governments agree to influence trade patterns directly, attempting to overcome obstacles to trade that cannot be easily negotiated away?
- Through efforts to avoid or to defuse international disputes over trade matters or through more aggressively confrontational policies to force other nations to remove trade barriers?

There are respectable arguments on all sides of these issues, and the debates over appropriate trade policies will not be resolved any time soon. Certainly, they will not be resolved in this report. What is critical, however, is that international discussion and cooperation on trade matters continue, that some tangible progress toward expanding world trade continues to be made, and that trade be governed by understandable and predictable rules rather than by the whims of national governments.

Although they are apparently out of fashion in U.S. policy circles these days, patience and persistence in trade matters will also contribute to U.S. economic security. The frustrations generated by years of only glacial progress toward opening Japanese markets do not provide an adequate justification for abandoning efforts (inevitably slow and painful) to identify and to eliminate specific barriers to U.S. products. Resorting instead to demands for immediate adjustment of particular bilateral sectoral trade imbalances—by administrative means if necessary—risks locking in place patterns of trade that may be seen as beneficial today but cannot remain so indefinitely. If trade patterns are set today by government agreement rather than by market forces, what in the future will constitute an acceptable signal that these patterns should change?

For all of its size, diversity, and capacity for self-sufficiency, the United States is the world's largest trader, and consequently we have a major stake in preserving a smoothly functioning system of international trade. If the United States withdraws even a part of its support for market-determined trade, who else will step forward to preserve what may be the most important economic achievement of the postwar era?

A STABLE INTERNATIONAL FINANCIAL ENVIRONMENT

The modern financial environment is truly global. Capital flows almost perfectly freely these days among the world's major financial centers, and financial disturbances in any of these centers will be felt in all of the others. Stable and well-functioning U.S. financial markets will be possible only within a stable and well-functioning international financial environment. Thus, international financial stability will be a central objective of U.S. economic-security policy.

Exchange-Rate Management

It has been 20 years now since the final collapse of the system of fixed but adjustable exchange rates that was first outlined at the Bretton Woods conference of 1944. These years have been marked by dramatic swings in real exchange rates (exchange rates adjusted for differences in national price levels), which in turn have profoundly altered the international competitive prospects of firms all over the world. Entire industries and the jobs associated with them have been created in one country or lost in another as a consequence of exchange-rate movements. Workers have been displaced, and still-usable capital equipment has been idled. In the past 20 years, exchange-rate volatility and the sudden changes in national economic policies enacted (wisely or otherwise) to counter exchange-rate movements have constituted some of the most serious sources of uncertainty, and thus of economic insecurity, facing firms and individuals in the United States and throughout the world.

Volatile exchange rates are also seen by some as undermining support for market-driven trading regimes. If market forces that determine success or failure in international markets include the effects of widely swinging exchange rates, then some would prefer a more stable, even if somewhat less efficient, trading system in which trade patterns are protected by quantitative trade restrictions or negotiated among governments. But when governments rather than market forces determine the details of trade flows, routine commercial matters become political, and the potential for political confrontation over trade matters increases. Also, government efforts to counter the trade consequences of volatile exchange rates can have the effect of rigidifying world trade patterns, preventing necessary and desirable adjustments to changes in fundamental economic circumstances.

Finally, there is concern that fluctuating exchange rates may discourage certain types of investment. International investors may fear that their expected returns will evaporate as a consequence of an exchange-rate swing.[2] Domestic investors may shy away from sectors (manufacturing, for example) having a potential for foreign competition, preferring instead sectors (like some services) in which competition will be principally domestic and therefore not strongly influenced by unpredictable exchange-rate movements. Some have suggested that it is not a coincidence that growth rates of manufacturing productivity have declined worldwide since the collapse of the Bretton Woods exchange-rate system.

As with trade policy, there is considerable debate over the best methods for achieving increased exchange-rate stability. Some argue for direct efforts by governments to maintain fixed exchange rates. Others argue that fluctuating exchange rates are merely the symptoms of more fundamental failures by governments to pursue non-inflationary economic policies and that wiser and steadier internal economic policies will bring exchange-rate stability as a by-product. There is little disagreement, however, that greater stability in real exchange rates than we have seen since the collapse of the Bretton Woods system would contribute both to overall prosperity (through increased trade and investment) and to international economic security (by reducing the likelihood of painful shocks).

[2]Many investment projects (building, say, a new factory) require years to complete. Unfortunately, forward foreign markets do not typically offer opportunities to hedge against exchange-rate movements more than about a year in the future. While forward currency contracts of longer maturities are written from time to time, the market for long-maturity futures is very thin. For practical purposes, investors cannot usually buy protection against the consequences of an adverse exchange-rate movement a few years in the future.

International Capital Flows and Economic Policy Coordination

Closely related to exchange-rate instability are large and unpredictable international capital movements. It is now possible (and routine) for portfolio managers to move tens of millions of dollars (or the equivalent in yen, deutsche marks, pounds, or francs) electronically across national boundaries or from one currency to another in a matter of minutes. So easy has it become to move very large sums that even the slightest hint that exchange rates may change triggers massive flows, which help to precipitate precisely the changes that were anticipated. In this sense, ever-improving facilities for managing large financial transactions have contributed to exchange-rate volatility. As repeated currency crises—most recently the European currency crises of September 1992 and August 1993—have illustrated, national monetary authorities are sometimes powerless to counter the effects of very large private capital flows.

Schemes for slowing down international capital movements are proposed from time to time. (The most common proposals usually involve some sort of transaction tax designed to "throw sand into the works" of international capital movements.) There is little support today, though, for efforts to control capital mobility. The rapid proliferation of new financial instruments in recent years has made it ever easier for portfolio managers to avoid specific national measures aimed at limiting international capital mobility; every new class of financial instruments creates a potential hole for would-be controllers of capital flows to plug. Most governments have recognized the impossibility of the task of effectively controlling international capital movements, and the thrust of most recent policy initiatives has, in fact, been in just the opposite direction—toward liberalization of financial markets.

In today's international financial environment, large flows of "hot money" and the problems they cause will be avoided only if national economic policies are sufficiently stable and consistent with each other so as not to create incentives for large cross-border or cross-currency flows in the first place. Thus, policymakers must choose the kind of economic security they want to pursue. On the one hand, they may seek to preserve their ability to set national economic policies independently of policies in other countries by insulating themselves from foreign economic and financial developments abroad. This provides a sort of economic security in the sense that insulation from international financial markets, if successful, preserves a nation's ability to control its own economic and financial destiny.

Alternatively, national policymakers can seek increased economic stability—and with it increased economic security—by giving up a degree of policy autonomy and making macroeconomic policy jointly with other nations.

There is considerable debate over the most effective operational strategies for pursuing international coordination of national economic policies, over the rigor with which international policy consistency should be pursued and over the wisdom in particular circumstances of sacrificing one macroeconomic goal (say, low inflation) for another (say, exchange-rate stability). Plausible approaches range from the very loose and informal consultative processes by which the G-7 industrialized countries try to manage their affairs, through efforts at explicit exchange-rate targeting, to the establishment of "convergence criteria" for national inflation rates or public deficits, all the way to full economic and monetary union, as proposed for the EU. Despite the debate over appropriate approaches to policy coordination, there is today a growing recognition that, as financial markets become more integrated, the former sort of economic security, based on isolation, becomes less and less practical. Increasingly, there is no practical choice but to pursue economic security through some sort of international policy cooperation.[3]

PROMOTING MARKET-ORIENTED ECONOMIC POLICIES

For a variety of reasons, the United States has an interest in promoting market-oriented economic policies in other countries. Both theory and experience suggest that market-oriented policies, with

[3]Ironically, even efforts to insulate a national economy from international financial instability would probably require careful international coordination, at least at the outset. A single nation suspected of contemplating a tax or other form of limitation on capital movements would experience massive capital flight as portfolio managers sought to put their assets beyond its reach. This kind of turbulence could be avoided only if a large group of nations were able to impose similar restrictions simultaneously.

minimal state involvement in production and distribution decisions, provide the most promising paths to economic growth.[4] Material prosperity is certainly not the only requirement for political stability, but in most cases it helps. Thus, promoting market-oriented economic policies abroad indirectly advances U.S. interests in international political stability. Also, market-oriented economic systems are typically pluralistic, with economic decisionmaking and the power to shape economic events distributed among many players, rather than concentrated in the hands of the government. To the extent that economic power offers access to political power, market-oriented systems may therefore advance U.S. interests in promoting pluralistic government abroad.

Finally, the advancement of market-oriented policies abroad may yield direct economic benefits for the United States. Market mechanisms and market forces dominate the functioning of the U.S. economy. The unfettered action of market forces will not necessarily produce the most desirable outcomes, however, when the market-driven U.S. economy interacts with government-managed foreign economies. As advocates of more aggressively interventionist policies repeatedly (and sometimes correctly) point out, U.S. reliance on market forces is not always the best course in the face of highly interventionist actions (subsidies, trade restrictions, etc.) by other countries.[5] But for practical as well as philosophical reasons, the United States is unlikely to change its own free-market orientation. If other countries are encouraged to adopt similar policies, the likelihood that U.S. free-market policies will turn out to be optimal is increased.

[4]This is not to say that all state intervention is necessarily counterproductive. The examples of Japan, South Korea, and Singapore come immediately to mind. Even in these countries, though, the state role was and is restricted to selected sectors in economies driven primarily by market forces, and the state role has decreased over time. It is hard to think of any country where economic performance has been enhanced by increasing the state role, and there are numerous examples of the opposite phenomenon.

[5]Whatever may be the shortcomings of market forces in particular circumstances, it is wise to bear in mind the all-too-frequent shortcomings of nonmarket alternatives. Government efforts to supersede or to improve upon market mechanisms can fall prey to bureaucratic ineptitude, maneuvering by special interest groups, and (occasionally) outright corruption. We should be wary of replacing a market failure with a "nonmarket failure."

One key to promoting the rise of market-oriented economic policies abroad will be making sure that countries pursuing such policies as part of development or economic-reform efforts enjoy access to dependable sources of international credit and capital. Ideally, development and reform efforts will be financed through private international credit markets—through lending by private international banks and through private foreign direct investment. International financial markets have expanded greatly in the last 20 years and now, in fact, do provide the bulk of the financing available to developing and reforming economies.

But private credit and capital markets will probably never become fully satisfactory or adequate channels for development and reform financing. In the past, for example, commercial banks have shown a tendency toward inconsistent and herd-like behavior with regard to development lending, all granting or withholding credit at the same time. In the late 1970s, for example, banks were quite eager to lend to developing countries, encouraging (in the eyes of some) considerable overborrowing. The "debt crisis" of the early 1980s, of course, brought a sharp reversal of attitudes, and even well-managed and perfectly creditworthy countries encountered difficulty in attracting necessary financing. Some other source of international credit—more dependably available than credit from private banks, less likely to be withdrawn at the first indications of trouble in a borrowing country—may be required. Similarly, foreign direct investors are unlikely ever to show much interest in social infrastructure projects like road-building, development of water systems, establishment of schools or hospitals, etc. Some other source of financing may be required for such projects.

Today, these gaps in international credit and capital markets are at least partially filled by official multilateral credit-granting institutions, such as the World Bank, the International Monetary Fund, and the various regional development banks. As a practical matter, supporting development and reform efforts will require continued support for these institutions, at least for the foreseeable future. Credit from official sources has not always produced the anticipated or hoped-for positive results. Arguably, such credit has in some cases served only to prop up inefficient economic systems or to perpetuate unsound policies in borrowing countries, actually delaying needed reforms. Existing multilateral credit institutions are far from perfect,

and efforts to improve these institutions and their policies are still required.[6] It may even be necessary to create new multilateral channels for development and reform finance.[7]

MAINTAINING A FUNCTIONING INTERNATIONAL COMMERCIAL AND FINANCIAL INFRASTRUCTURE

Modern commercial and financial life is complex. Routine activity depends on an extensive array of facilitating services: transportation, information, brokering, payment, credit, leasing, etc. Also necessary are commonly accepted rules and procedures for carrying out transactions. These rules and procedures cover such matters as dispute settlement, contract enforcement, and settlement of accounts payable. When these services are lacking or when the rules of the game break down, commerce is hindered. The economic well-being of U.S. residents depends on the smooth conduct of national and international commerce, and hence on the smooth and efficient functioning of what we might think of as a commercial and financial infrastructure. Preserving U.S. economic security requires protecting this infrastructure from accidental or intentional disruption.

Traditionally, the most basic elements of the international commercial infrastructure have been the freedom of peaceful international passage for trade purposes and the sanctity of property rights. Throughout its history, the United States has exercised its diplomatic

[6]High on the list of needed reforms would be a more careful delineation of the increasingly overlapping responsibilities of the IMF and the development banks. We might also seek, for example, increased lending to private enterprises rather than to governments in developing or reforming countries, more aggressive promotion of privatization programs, greater attention to the environmental consequences of development programs, or greater efforts to make sure that the benefits of economic growth and development are broadly shared within the borrowing country. Above all, there is a need for critical review of the effects of lending by the IMF and the multilateral development banks and of the policies they encourage borrowing countries to adopt. No one has a clear recipe for successful economic development or reform, and mistakes will inevitably be made. At the very least, we should learn from these mistakes.

[7]The difficulties that the Western industrialized democracies have encountered in trying to devise a unified approach to providing economic assistance to the former Soviet Union, for example, suggest that the existing multilateral institutions are not entirely adequate for such an important task. A workable framework for coordinated international assistance has yet to be devised.

and military muscle to protect U.S. access to international shipping routes. Similarly, the U.S. government has sought to protect U.S.-owned foreign assets from confiscation or expropriation. These and their modern-day variants (e.g., the right of peaceful overflight) will continue to be important objectives of U.S. economic security policy.

In recent years, we have come to recognize the importance of other elements of this infrastructure. Moreover, we have come to recognize that some of these additional elements are vulnerable to disruption and are therefore appropriate objectives for policies aimed at enhancing U.S. and international economic security.

Of particular concern in this regard is the international banking system. In today's world, commercial banks play an essential role in international trade and investment. They facilitate international payments, provide short-term trade financing and related trade documentation services, guarantee payment among parties who do not have recourse to common legal systems, channel funds from countries with savings surpluses to countries with savings deficits, and generally provide the lubrication necessary to keep the wheels of international commerce turning. If the international banking system is weakened or if parties to transactions begin to doubt the reliability of international banks, the volume of international credit and other financial services will be restricted, generally to the detriment of international trade and investment. More catastrophically, a failure of one bank can render the claims of other banks uncollectable, possibly causing these other banks to default on their obligations, and so on. If the original defaults are of sufficient size, the result can be a sudden and widespread contraction of credit and banking services. For these reasons, the stability of the international banking system and the soundness of individual banks doing international business have come increasingly to be seen as "international public goods" in which all nations have an interest, which no nation can obtain solely through its own efforts, and for which therefore all nations bear a degree of responsibility.

Recent years have seen some progress toward strengthening the international banking system. International agreements have been concluded delineating, for example, the responsibilities of national authorities in regulating the activities of international banks, clarifying which central banks bear responsibility for serving as "lenders of

last resort" for banks facing liquidity difficulties, and establishing international standards for bank capital adequacy. These agreements mark significant steps forward in removing potential sources of international economic uncertainty and instability. Much remains to be accomplished in this regard, however. The recent collapse of the Bank of Credit and Commerce International (BCCI) is a reminder that oversight arrangements for banks operating in multiple countries are still something less than satisfactory. Also, the international community is still struggling to establish capital adequacy standards for securities firms undertaking international business.

A more recent concern has been the potential vulnerability of electronic clearing arrangements (the so-called financial wires) through which banks settle accounts with each other. The volume of funds routinely moving over the financial wires is staggering. The flow of funds through the Clearing House Interbank Payments System (CHIPS), the principal system for international interbank transfers, is estimated at the equivalent of $1 trillion *per day.* Because of timing differences in when funds are debited and credited, operations of the financial wires produce enormous volumes of very short-term, intraday credit. Failure of a clearing system, whether a result of computer malfunction or malicious action, could have severe financial repercussions: Funds expected by banks would not arrive, making it impossible for these banks to meet their obligations to other banks, and so on down the line. Responsibilities for regulating international financial wires and for intervening in the event of trouble are not well spelled out today.

Some troubling gaps have also become apparent in the structure of international agreements regulating international trade and investment. International protection of intellectual property rights, for example, is far from adequate today, and U.S. residents—because they create a large share of the world's intellectual property—are among the principal victims of this inadequacy. The absence of an effective enforcement mechanism for international trade agreements causes difficulties for many countries and has led to some dangerous confrontations over trade matters. In 1992, for example, after five years of fruitless efforts to convince the European Community to comply with international rulings regarding agricultural subsidies, the United States saw no alternative but to threaten strenuous retaliatory action unless the EU changed its policies. In the event, the EU did back down, but only after exposing the United States, Europe, and perhaps the rest of the world to the possibility of a ruinous trade war. A third gap in the international rules of the game is the absence of effective international competition policy—extensions of national anti-trust laws to prohibit the cartelization of international markets by combinations of firms from several countries. The EU is working its way toward a Union-wide competition policy, but as yet no similar effort has been launched toward the rest of the world.

EQUITABLE INCOME DISTRIBUTION

True national security—of the military or the economic variety—requires a unified populace with a common understanding of national interests and capable of standing together in the face of foreign challenges. Essential to this kind of national unity is a shared perception that "we are all in this together," that all citizens are being treated fairly, and that no part of the population is granted special favors or called upon to make special sacrifices. In the economic sphere, this translates into a requirement to maintain a distribution of income and economic well-being that is perceived to be broadly fair and that does not exclude large portions of the population from the general prosperity.

There has been much discussion in the last two or three years of the apparently widening gap between the top and the bottom of the U.S. income distribution. Although there is disagreement over the full set of factors that may have contributed to this widening, there is a general recognition that the increasing openness of the U.S. economy has complicated the task of maintaining the incomes of the poorest and least skilled U.S. residents.

Most Americans have benefited from the fuller integration of the U.S. economy into the larger world economy. New markets have been opened for U.S. products, and U.S. consumers now enjoy a wider choice of goods available for purchase. But lower-skilled U.S. workers increasingly find themselves in competition with the enormous pool of low-skilled and low-paid labor in the rest of the world. The results are lower wages for low-skilled U.S. workers. When wages can go no lower because of minimum-wage laws, low-skilled workers simply lose jobs. A continuing flow of low-skilled immigrants compounds the problem.

The ideal response to growing competition for low-skilled jobs in the United States is to improve the skill levels of U.S. workers, so that they will no longer have to compete with low-paid foreign workers. This is, of course, much more easily said than done. Theories about how to train better workers abound, but few programs have shown clearly successful results in practice. In even the most optimistic scenarios, years will be required to bring about significant improvements in the skills of the least-educated U.S. residents. A second-best approach would be to provide tax relief or income supplements for the working poor and enhanced benefits for the unemployed, to maintain their incomes at what are perceived to be acceptable levels for U.S. citizens. But proposals for such income transfers create what many consider undesirable incentives and often face stiff political opposition.[8]

When efforts to raise skill levels or to supplement the incomes of low-skilled workers are unfeasible or ineffective, governments face pressures to protect low-skilled workers from the consequences of international competition by limiting imports of foreign goods. (Concern over wages and employment opportunities for low-skilled U.S. workers generated serious opposition to a free-trade agreement with Mexico.) While protectionist policies may indeed improve the lot of some of the poorest U.S. workers, they will almost certainly reduce the overall level of prosperity in the United States, by driving up the prices that all consumers must pay for affected products and by inviting protectionist policies in other countries. As difficult as other approaches may be, trade restrictions cannot be an appropriate tool for maintaining an equitable income distribution and social harmony.

Some progress toward raising the incomes of the least skilled might be achieved by trying to promote increased productivity in industries that employ low-skilled workers. Doing so, though, would require a reversal of current conventional wisdom about what sorts of industries should receive special assistance or encouragement from the government. Emerging high-technology industries are the most frequently suggested targets for special government assistance, and,

[8]But not always. Changes in U.S. tax law enacted in 1993 increased the earned income tax credit.

as we have already noted, there are plausible arguments in favor of support for some of these industries. But there may also be good social reasons for focusing public policy on a very different set of industries: those that provide employment for lower-skilled and less-well-educated workers. Public resources devoted to improving production efficiency in U.S. high-technology industries might conceivably be better spent in efforts to improve the productivity (R&D, perhaps, or subsidies for capital investment) and thus the wages of lower-skilled workers in other, relatively "low-tech," industries.

Generally, professionals and highly skilled production workers in the United States do not have a difficult time finding employment. Recessions and structural changes in the economy (like the current reductions in defense production) do, of course, displace highly trained workers from time to time; but unemployment rates for well-educated workers generally remain low.[9] Consequently, there is probably not a lot of social gain in creating increased employment opportunities for the highly skilled. Because such workers usually require extensive education or training, the supply of skilled workers cannot be expanded quickly to meet increased demand. Promoting growth in industries that make heavy use of skilled workers may do nothing but bid up the wages of the limited supply of skilled workers available.

The circumstances of less-skilled workers may be very different. There seems to be a more or less constant reservoir of unemployed low-skilled workers in the United States. Continuing immigration may add to this oversupply. Unemployment rates for poorly educated workers are high, and these high levels of unemployment can give rise to a variety of social ills that impose costs on all parts of society. It may be that social cohesion and the longer-run economic

[9]A Department of Labor study found the following unemployment rates for workers with varying levels of educational achievement in 1987:

Less than four years of high school	11.1%
4 years of high school	6.3%
1 to 3 years of college	4.5%
4 years of college or more	2.3%

See Wayne J. Howe, "Education and Demographics: How Do They Affect Unemployment Rates?" *Monthly Labor Review*, January 1988, pp. 3–12.

security of the United States are better served by government programs that aim to promote industries that will provide jobs for less-skilled workers and to promote technical innovation that will increase the productivity—and thus the wages—of lower-skilled workers. Rather than seeking better ways to make semiconductors or advanced airframes, perhaps public resources should be directed to revitalizing, say, the U.S. textile, garment, or food-processing industries or other industries that are commonly thought of as "low-tech."